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TAGS: ECON EINV PREL KS KN

SUBJECT: THE DPRK ECONOMY: UPDATE ON KAESONG INDUSTRIAL  
COMPLEX

REF: 07 SEOUL 1189

Classified By: Acting DCM Joe Yun for Reasons 1.4 (B&D)

SUMMARY

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¶1. (C) Most of the South Korean firms operating in the DPRK's Kaesong Industrial Complex (KIC) remain satisfied with business conditions there, according to ROKG officials and company representatives. Newly arriving companies also seem confident about their investment plans over the longer term. Apparently undeterred by the DPRK's March expulsion of ROKG officials from the KIC and rising uncertainty about inter-Korean economic cooperation, only 3 out of 112 firms preparing to enter the KIC this year have dropped out of the project to date. Inexpensive labor seems to be the KIC magnet attracting South Korean investors. Some analysts calculate that DPRK workers are about half as expensive as Chinese laborers, while their productivity is about 80 percent of the Chinese level, making the DPRK workers a relative bargain.

¶2. (C) Although the KIC remains an attractive investment site, the project's expansion is likely to be put on hold while the inter-Korean economic cooperation talks are stalled. New firms preparing to set up their KIC operations will need approximately 80,000 additional workers by the end of 2008, and half of this work force may require housing in a ring of dormitory buildings to be built around the KIC factory area. Hyundai Asan (HA), the KIC's sole builder, reports that North-South governmental talks on the dormitories were recently halted, with no indication of when they will be restarted. Without official agreement to break ground on the dormitories in the coming weeks, HA worries that several firms may have to delay the launch of their operations, thereby discouraging other investors. On the other hand, the DPRK could find another solution to ROKG-funded housing in order to maintain ROK investor confidence and avoid losing KIC worker revenue. END SUMMARY.

KIC LABOR COSTS

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¶3. (C) The DPRK work force at the KIC currently totals about 20,000 workers working at 69 firms (and an additional 3,000 construction workers). These workers are reported to be capable, reliable, versatile, and, above all, cheap. The average worker earns \$76 per month including overtime.

Worker wages are paid directly to the DPRK authorities in U.S. dollars, generating about \$1.7 million per month in DPRK revenue. The DPRK authorities, in turn, tax workers at a 30-percent rate and pay them the remainder of their salary half in DPRK Won and half in coupons for use at special stores in Kaesong City. It is difficult to determine how much these coupons are worth, but a KIC worker's income appears to be substantially higher than that of the average DPRK worker, according to Lee Seog-ki at the Korea Institute for Industrial Economics and Trade.

WE ASKED KIC FIRMS: "IS BUSINESS GOOD?"

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¶4. (SBU) With the completion of its initial 3.3-million square meter expansion in the fall of 2007, the KIC is now poised to absorb an additional wave of 112 ROK companies by the end of 2008. Three of these companies recently opted out of their investment plans, but the remaining firms are reportedly anxious to complete their factory construction and begin operations, according to Ministry of Unification and KIC management company officers. The new entrants include two PRC light manufacturing enterprises that will join two other foreign firms -- a Japanese packaging company and German auto parts manufacturer -- already in operation at the KIC.

¶5. (SBU) To assess prospects for this new investment wave into the KIC, Econoff recently visited the managers of three companies operating in the KIC for more than two years -- SJ Tech, SoNoKo, and Cotton Club -- as well as KICOX, the South Korean corporation that opened a factory apartment building for 32 smaller South Korean firms in August 2007. These companies represent a cross-section of the 69 companies currently running labor-intensive manufacturing operations at

the KIC. Their products range from watches and auto parts to kitchen utensils, apparel, and shoes. The KIC's monthly industrial output amounted to \$18.9 million in January 2008, of which \$3.2 million was exported mainly to markets in developing countries.

SJ TECH: "THE PIONEER"

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¶6. (SBU) CEO Yoo Chang-geun of SJ Tech, a maker of hydraulic pumps, claims to have been the first South Korean investor to sign up for the KIC in September 2004. Yoo's KIC operation produces rubber rings that are shipped to South Korea for final assembly into pumps for domestic sale. Yoo opted for the KIC over China chiefly because of the KIC's low-cost labor, Korean language usage, and the ROKG's investment guarantee program protecting his plant equity from political risk in the DPRK. Since 2004, SJ Tech has sunk about \$8 million into the KIC, well above the ROKG's political risk guarantee of 5 billion won/\$5 million per company.

¶7. (SBU) Yoo is pleased with his KIC labor force. He claimed DPRK worker productivity is almost equal to that of workers in his ROK plant -- at only five percent of the salary. While he must train his workers for about 2 years, Yoo claimed his company has experienced little labor turnover, thereby helping him to reach the break-even point on his investment by mid-2007. SJ Tech's DPRK labor force currently totals 1,320 workers, with plans to employ an additional 380 workers once a third factory building is completed in late ¶2008.

8.(C) Yoo said he was "not worried" that the DRPK's late March expulsion of ROKG officials from the KIC and the ensuing "freeze" in inter-Korean relations might slow down inter-Korean economic cooperation talks. He noted that improvements in passage, communications, and customs would "make his life easier" but they were not essential. Yoo indicated he had gotten into the KIC early enough to forge his own contacts with DPRK authorities and would rely on them to recruit additional workers for his new factory opening in

late 2008. Yoo acknowledged, however, that labor shortages, if they did emerge, would put his expansion plans on hold.

SONOKO CUISINEWARE: "OLD BUT GOOD WORKERS"

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¶19. (SBU) SoNoKo's owner, Kim Suk-chul, claims to be the first ROK investor to begin operations in the KIC, just ahead of SJ Tech, in late 2004. SoNoKo (derived from "South and North Korea") makes kitchenware (primarily cookware, flatware, and shopping bags) for sale in South Korea and, until recently, Mexico. Kim told us he has invested \$3.5 million of his own money along with a \$2.3-million loan from the Inter-Korean Cooperation Fund in his KIC plant.

¶110. (SBU) Kim stressed SoNoKo was the first company to introduce KIC-produced goods into the South Korean market. Its kitchenware was apparently an instant hit, with annual sales climbing from \$2 million in 2005 to \$3 million in 2007. During that period, however, the going has gotten tougher, mainly because of the loss of the company's only overseas market. Kim is currently pinning his hopes on a trial shipment of product to Germany. Kim claimed that Germany would have no problem with his "Made in Korea" labels and would constitute his first beachhead into more profitable West European markets.

¶111. (SBU) SoNoKo's operations are limited to its KIC factory, with 450 DPRK workers and 6 South Korean managers. The ratio was originally 270 to 13, but Kim explained that a rise in DPRK worker productivity had allowed him to reduce the number of more expensive South Korean employees. When his DPRK workers first began working, their productivity level was about 20 percent of that of South Korean workers in the 1970's and 1980's, when South Korea's kitchenware industry was flourishing. Kim estimated that his KIC workers are now up to about 60-70 percent of the South Korean productivity level. Kim added that his DPRK worker productivity was achieved with an age handicap. The average age of his work force is 35, compared with the overall KIC average of 30

years-of-age.

¶112. (C) Kim told us he suspects that some of his employees are DPRK agents, because theft from his factory remains a persistent problem. He claimed that the thievery, while small, would be quickly corrected if it were not sanctioned by local DPRK officials. Kim added that about 50 of his DPRK employees have left his company to date. This labor turnover is not high, but it is unusual for most KIC firms. Kim suspected the DPRK government had recalled the employees for work elsewhere in the North. No other KIC executive made similar claims to us. Turning to policy changes under President Lee, Kim opined that KIC expansion would likely come to a standstill in 2009, if President Lee could not restart inter-Korean economic talks by that time. He predicted even ROK companies already in the KIC might become more cautious about further investment in the absence of forward movement on the project.

COTTON CLUB: "KIC IS BETTER THAN CHINA"

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13. (SBU) President Kim Bo-seun of the Cotton Club -- an underwear manufacturer also operating in Jeonju, South Korea and Yentai, China -- launched KIC operations in August 2006. Kim initially hired 12 North Koreans and sent them to his PRC plant for six weeks of training. Returning to the KIC, they served as lead workers and floor managers for other DPRK employees, now totaling 700.

14. (U) Kim claims to have witnessed a "great improvement" in DPRK worker productivity since his early days in mid-2006. Originally incommunicative with his company's South Korean managers, DPRK workers now communicate openly and actively.

Kim claimed that these improved relations stem from the linkage DPRK workers have drawn between improving productivity and earning higher pay.

¶15. (C) The KIC factory currently accounts for approximately 30 percent of Cotton Club's total output, with the PRC factory producing 60 percent and Jeonju 10 percent. In light of the PRC's rising labor costs, high labor turnover, and declining tax benefits for certain investors, Kim plans to scale-back his PRC operations in favor of expansion in the KIC over the long term. His views have radically changed since our last visit with him in April 2007, when he professed that he would never move a significant share of his production to the KIC because of the DPRK's high political risk. At present, he is hoping KIC operations can expand to produce 60 percent of the company's total output, displacing China as the company's primary production site. To help meet this goal, HA is nearing completion of a second factory building, to be staffed by 1,400 new workers in late 2008.

¶16. (C) Kim said his company is making a profit but had relied on a low-interest Inter-Korean Cooperation Fund loan to establish its first KIC factory. His new factory was being privately financed at a 5.5-percent interest rate compared to his first loan rate of 4.3 percent. Like his business colleagues, Kim was optimistic that the March expulsion of ROKG officials from the KIC would not impinge on his company's operations. Indeed, he noted that some DPRK officials had privately assured him that those expulsions would not affect the DPRK's KIC policy going forward.

#### KICOX: BUILDING APARTMENT FACTORIES

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17.(U) KICOX is a South Korean parastatal corporation supervised by the Ministry of Knowledge-based Economy. It manages nearly 30 industrial complexes throughout South Korea that have contributed significantly to the country's rapid industrial development over the past few decades. Indeed, KICOX literature claims that its various factory complexes are currently producing one-third of Korea's industrial output and half of its exports.

18.(U) Moving into the DPRK last year, KICOX opened its first complex at KIC in August 2007. All of the 32 small- and medium-size manufacturers now housed in the "apartment-style" factory complex are low-tech, labor intensive operations (predominantly making apparel and other textile products).

KICOX's KIC Assistant Manager Hong Young-ki recently told us these companies have quickly ramped up their operations, and now employ about 3,200 DPRK workers. Hong noted that the firms are all financially stable, having been carefully selected for their financial strength, viable business plans, and extant operations in South Korea or elsewhere.

19.(SBU) Confident of its KIC success, KICOX signed a contract with DPRK authorities and HA to build a second factory building in July 2007. Construction is scheduled to begin in September 2008, with companies selected in the summer of 2009 and likely to begin operating by the end of ¶2009. Hong noted that it should be easier to fill this second building because KICOX plans to relax its rule on admitting only labor-intensive companies. Overall, KICOX and KIDMAC, the general North-South management organization operating under Ministry of Unification auspices, plan to build 32 factory building at KIC over the long term.

¶20. (C) Hong was confident that the new KICOX complex at the KIC would be adequately staffed over the long term. He did admit to following the North-South talks on constructing six dormitory buildings that would ring Phase One of the KIC -- and acknowledged that further delays in finalizing that agreement might contribute to labor shortages over the long term at KIC. On the other hand, he was optimistic that the KIC's higher pay would continue to be a drawing card for new workers, while the DPRK government seems to be "counting on" continuing flows of hard currency from worker incomes. In a

related discussion, Hyundai Asan Senior Vice President Jang Whan-bin seemed more worried about the stalled talks on the dormitory buildings. He noted that new ROK firms are expecting young workers, mostly women in their twenties, and the neighboring metropolitan area of Kaesong City may have already supplied most of its available work force. While wryly noting DPRK population census numbers are unreliable, Jang opined that the dormitories are probably essential to bring in about 40,000 of the 80,000 new workers needed by the end of 2008.

COMMENT

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¶21. (SBU) This KIC survey is notable for the generally favorable opinions voiced by South Korean firms about their DPRK work forces and their likely prospects for long-term success. Despite a new Lee government policy to link further KIC expansion to progress on denuclearization and other issues, most of our interlocutors feel that the KIC is now on a self-sustaining growth trajectory that could eventually rival low-cost labor sites in China, Vietnam, and other countries. It is clear, too, that their business decisions are motivated by profit margins and not sentimentality or a desire to accelerate reunification. Just as important, we heard more about the increasing exposure of DPRK workers to market principles, with some workers learning advanced work skills. As they receive decent treatment and tangible fringe benefits from their South Korean employers, these North Koreans workers may be starting to understand the market value of their work.

22.(SBU) Development of the KIC has fallen behind the ROKG's original schedule. This delay is partly attributable to construction delays; to the DPRK's slow bureaucratic process of approving business-related decisions; and to recent uncertainty about President Lee's policy of "reciprocity" with the DPRK. The KIC's long-term success may ultimately depend more on DPRK officials who will need to ensure that the KIC's generally positive business climate extends to newly arriving companies. While hundreds of visitors -- mostly South Korean -- are now traveling to Kaesong City as part of HA's new tourism program introduced last December, there are still many unanswered questions, including the number of workers available to work at the KIC, the DPRK process for selecting these workers, how much their retained earnings are worth, and whether South Korean businesses will continue to receive subsidies from the ROKG.

23.(SBU) Nonetheless, the KIC is moving forward. Its next challenge will be to determine whether the planned six new dormitory buildings are vitally needed to keep workers flowing into newly established ROK factories, as early as the end of 2008. It might well be the case that the new

dormitory buildings are not needed since the DPRK government has not yet signaled any problem with worker availability. On the other hand, the DPRK might also be playing a waiting game, counting on the ROKG and its business constituency to find another way to bring the construction project to fruition without formal ROKG consultations. Paradoxically, the DPRK authorities may even be calculating that the dormitory question will be resolved somehow in favor of market benefits for both sides of the border. End Comment.

VERSHBOW